The Director of Central Intelligence
Washington, D.C. 20505

National Intelligence Council

NIC #03642-84/1
12 September 1984

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

FROM: Maurice C. Ernst
National Intelligence Officer for Economics

SUBJECT: The Costs of the Soviet Empire: A Rejoinder

1. Attached is a rejoinder to my memorandum "Perspectives on the Economic Burden of the Soviet Empire" of 11 June, prepared [redacted] 25X1 [redacted] who asked that it be distributed to the recipients of my memorandum. As you will see, [redacted] 25X1 treats my memo as if it were intended solely as a critique of his paper, "The Costs of the Soviet Empire." Although I prominently discussed my conceptual problems with his study, the primary purpose of my memo was to examine different facets and perspectives on the problem so that the US Government would have a better understanding of Soviet behavior and on whether and how we may be able to exploit this behavior. I did not argue that a respectable theoretical argument could not be made for the [redacted] 25X1 approach, but rather that this approach is only one of many that could be used, and that it can give misleading results if the estimated "burden of empire" is added to the defense burden or if it is treated as representative of Soviet perceptions.

2. As you will see, the [redacted] 25X1 critique is defensive and at times deals with nitpicks rather than important differences. Apart from the nitpicks, three major differences emerge:

o [redacted] 25X1 believes it is "appropriate and useful to think of the empire as an enterprise, and to think of the costs of managing an empire as analogous to the costs of managing a firm." This economic abstraction may be useful to help in establishing criteria for measuring costs, but in my opinion it ignores the considerable differentiation in Soviet policies and institutional dealings with various groups of countries--Communist countries, other clients, and Third World

25X1 [redacted]

client states. This differentiation seems to me critical in any understanding not only of what costs Moscow is willing to incur, but also of how it assesses these costs.

o [redacted] believes, and I agree, that valuing Soviet trade with client states in terms of the best prices Moscow could have received or paid for the same products in the West is a theoretically legitimate way to calculate price subsidies, which are in turn the major element in the cost of empire. In a Communist state, with a command economy heavily insulated from the Western market, however, it is not at all evident that potential trade with the West will always be viewed as the most relevant alternative for trade with the "empire." 25X1

o Although [redacted] does not explicitly add his estimates of the "burden of empire" in rubles to the defense burden, he strongly suggests that this should be done. I believe that this procedure would yield inflated measures of economic burden. The calculation of defense burden is designed to reflect the costs of the factors of production (labor, capital, and land) used for defense purposes. A comparable measure of the burden of empire would be to subtract the domestic factor cost of producing exports to the empire from the factor cost of producing domestic substitutes for imports from the empire. This is a very different concept from that used [redacted] and I suspect would yield a much smaller measure of burden. 25X1 25X1

3. I will be talking to [redacted] on these and related issues during a brief visit to Los Angeles next week. 25X1

[redacted] 25X1

Attachment,
As stated

NIC #03642-84/1
12 September 1984

SUBJECT: The Costs of the Soviet Empire: A Rejoinder

DCI/NIC/NIO/Econ:M.Ernst:bha(12 Sept 84) [redacted] 25X1

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The Director of Central Intelligence
Washington, D.C. 20505

National Intelligence Council

NIC #03642-84
21 June 1984

MEMORANDUM FOR: See Distribution

FROM: Maurice C. Ernst
National Intelligence Officer for Economics

SUBJECT: Perspectives on the Economic Burden of the Soviet Empire

The recent surge in interest about estimates of the burden of empire on the Soviet economy has raised a number of important issues. I have prepared the attached memorandum to try to clarify some of these issues. I welcome your comments.

Maurice C. Ernst

Attachment,
As stated

25X1

All portions Secret

NIC #03642-84
21 June 1984

SUBJECT: Perspectives on the Economic Burden of the Soviet Empire

DCI/NIC/NIO/Econ:M.Ernst:bha(20 June 84) [redacted] 25X1

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Perspectives on the Economic Burden of the Soviet Empire

Key Judgments

[redacted] recently has estimated the "burden of empire" at nearly $50 billion a year and 7 percent of Soviet GNP. That study raises important questions. 25X1

(1) Are Soviet national security and foreign policies creating more pressure on the Soviet economy than present CIA estimates of defense spending indicate--that is, might a broader definition of those expenditures, to include the "burden of empire" increase the share of GNP from CIA's estimated 14 - 15 percent to over 20 percent?

(2) Is the apparently growing burden of empire a significant factor in the Soviet economic slowdown?

(3) Does the Soviet "burden of empire" give the US opportunities for leverage and influence?

There are major conceptual problems and uncertainties in assessing the "burden of empire." [redacted] includes all kinds of foreign assistance, but a 25X1 strong case can be made for including only the cost of supporting Communist countries because other countries generally limit their dealings with the USSR to arms purchases, often on concessionary credit terms, and a small volume of trade. More serious is the question of how to treat the so-called "price subsidies" in Soviet trade with Communist countries, especially with Eastern Europe. These "subsidies," which constitute a large part of the estimated costs, represent hard currency earnings (or their equivalent) foregone mainly by charging prices below the world market for Soviet oil exports to Eastern Europe and paying above-market prices for Soviet imports from Eastern Europe. They are hard to measure in dollars; even more so in rubles. And they raise unresolvable questions about what the real alternatives for the USSR were regarding trade with its allies. Considering these uncertainties and ambiguities, a reasonable estimate of the "burden of empire" would be considerably smaller than [redacted] estimate 25X1 of 7% of GNP and could be as low as 1%.

For decades the USSR has provided a protected market for East European exports of manufactured goods which are generally not competitive on the world market. In return, the Soviets have exported to Eastern Europe fuels and raw materials that could be sold on the world market. The Soviet economy has certainly benefited from this trade not only because East European products are often of higher quality than Soviet products, sometimes thanks to imported Western technology, but also because supplies are reliable and can be planned. The fact that the Soviets would probably get better value in return for their exports of fuels and raw materials in Western markets than in Eastern Europe can be viewed as a cost of having

integrated the East European economies into the Soviet Bloc. But this integration also carries major political and national security, and indirectly economic benefits--e.g., how much more would Moscow have to spend on defense if its military forces were not in Eastern Europe--and the Soviet costs incurred in trade with Eastern Europe are in many ways similar to those which result from inefficiencies in the Soviet economy itself.

The massive leap in world oil prices in 1973 and in 1979-80 had major repercussions on Soviet trade with Eastern Europe. Typically prices of primary products in Soviet exports to Communist countries are based on an average of world market prices over several years, in the expectation that they will reflect long-term trends while avoiding drastic fluctuations. But in the case of the oil price increases, which were not cyclical, these pricing procedures became a form of temporary Soviet assistance to enable Eastern Europe to avoid the oil price shocks suffered in the West and adjust their economies more slowly. At peak in 1980, Eastern Europe was paying some $20 billion less for Soviet oil than could have been obtained in Western markets. Since then, however, this so-called oil price subsidy has disappeared.

There is little ambiguity as to the existence of a substantial Soviet economic burden from economic and military support of other Communist countries, especially Cuba and Vietnam. Because these countries have Communist governments and are extremely important foreign policy and strategic assets for Moscow, the Soviets have little choice but to support their economies and military establishments. The Soviets provide Cuba and Vietnam with all their military and most of their economic import requirements and get very little of economic value in return although they obtain large military and political benefits. The value of Soviet assistance to these two countries is in the range of $4 to 8 billion, depending on world prices at the time. We have no good measure of the domestic cost of this aid to the Soviet economy, but Moscow obviously believes it to be heavy.

Most Soviet aid to non-Communist Third World countries goes to clients whose governments need Soviet help to stay in power (Ethiopia, Angola, Mozambique, Nicaragua), and to a few countries which are politically largely independent of Moscow, but which have some important common foreign policy interests with the USSR (Syria, Iraq, Libya, India). This aid is mostly military. Most Soviet arms are paid for, but Moscow has been willing to defer payments where necessary (as currently in the case of Syria).

The total cost of aid to non-Communist client states as well as of assistance to other Third World countries, which largely takes the form of low interest military credits, is small. Soviet weapons, exports of which are financed by these credits, are generally produced on a large scale and cheaply. With regard to Third World economic aid, Moscow has not even tried to compete seriously with the West for more than a decade. In

particular, the Soviets have consistently refused to provide any hard currency or, with few exceptions, general balance-of-payments aid.

Over the years, Moscow has been far from generous in providing assistance to foreign economies, and the growing economic stringencies in the USSR in recent years appear to have contributed to a toughening Soviet posture in trade and aid negotiations with allies and clients, alike. Moscow is trying to further increase its gains from trade with Eastern Europe, even at the expense of those countries' already low economic growth and to limit its economic aid to Cuba. Moreover, Soviet public statements and actions suggest a strong Soviet desire to avoid open-ended aid commitments to client states, such as Ethiopia and Angola.

Certain US actions could either raise the cost to Moscow of maintaining its influence in third countries, or induce a decline in Soviet influence if Moscow were unwilling to incur larger costs. The potential for US influence depends on the importance to Moscow and to the particular third country's government of its relationship with the USSR, and on the amount of leverage the US, with its Allies, can exercise--which in turn depends primarily on the particular country's dependence on economic relations with the West.

Western actions could increase the cost to Moscow of maintaining its East European empire, but would not be likely to reduce Soviet control over and influence in those countries. Unilateral US economic leverage, however, is small because East European countries trade mainly with Western Europe and some developing countries, and Western cooperation is difficult to obtain. Moscow almost certainly would be willing to accept an increased economic burden in order to protect its principal Communist LDC clients, especially Cuba and Vietnam, from the impact of Western economic sanctions. Cuba's status as a bastion of Communism in the Western hemisphere not only provides a major base for Communist penetration in Latin America, but also diverts major US military forces from other uses. As a major power in Southeast Asia, a Communist Vietnam also is a useful springboard for Soviet influence and in addition ties down large Chinese forces along the border. Western ability to increase the burden to Moscow of supporting these countries, however, is limited by the fact that only a small share of their trade is with the West.

The best opportunities to use Soviet "costs of empire" as a basis for policy leverage probably exist in the non-Communist client states--Angola, Mozambique, Ethiopia, South Yemen, and perhaps Nicaragua. Moscow has large foreign policy interests and some military interests in these countries, and already incurs substantial costs to preserve the relationship. But the West, not the US alone, retains major potential leverage because it still provides the sources of most of the countries' export earnings and government revenue. Major Western economic sanctions or inducements would substantially raise the costs to Moscow of protecting its political and military interests. Perhaps more likely in some cases, given the Soviet

reluctance to incur such added costs, would be a weakening of Soviet ties. The fundamental problem is the great difficulty of achieving any substantial coordination among Western countries in the use of policy instruments.

Introduction

1. A recent study [redacted] has called attention to the growing burden to the Soviet economy of maintaining and expanding the Soviet empire. [redacted] estimates the "burden" as reaching about $50 billion around 1980, and as constituting up to 7 percent of Soviet GNP. The implication is that this "burden" adds considerably to the already massive defense burden, bringing the overall cost of national security activities to over 20 percent of Soviet GNP, and is an important factor of slowing Soviet economic growth and holding down living standards. 25X1 25X1

2. These estimates, however, are misleading for two principal reasons:

- [redacted] includes in its concept of "empire" all Soviet costs involved in relations with both Communist and non-Communist countries, plus expenditures for military operations in Afghanistan and heroic estimate of the cost of Soviet foreign intelligence operations. Such an all-encompassing definition of "empire" obscures the great differences in Soviet economic, military, and foreign relations with different groups of countries and makes meaningful international comparisons of burden difficult. CIA, defining the Soviet "empire" as including only Communist countries, and using a somewhat more conservative methodology [redacted] estimates the burden at about $25 billion. The cost of Soviet military operations in Afghanistan, estimated to be the ruble equivalent of $3 billion annually during 1981-83, is included in CIA estimates of Soviet military expenditures. 25X1 25X1

- Estimates of Soviet costs, both by [redacted] and CIA, include both costs actually incurred--that is, those representing a transfer of real resources from the USSR to foreign countries or a claim on the Soviet budget--and the value of economic opportunities foregone--that is, the dollar earnings Moscow could have obtained if it had charged full market prices instead of the lower prices actually charged, for some of its exports, notably oil, to Eastern Europe and Cuba, or the domestic ruble value of the imports that could have been purchased with these added export earnings. The meaning of these "opportunity costs" is highly ambiguous. To fully realize these opportunities, Moscow would have had to accept fundamental changes in the East European and Cuban economies, with 25X1

[redacted] 25X1

unpredictable effects on political stability and Soviet defense requirements.

3. This memorandum will examine the following questions:

- The nature of the Soviet relations with various groups of states, which influence the need for Soviet assistance and Moscow's willingness to make assistance available.
- The types of "costs."
- The magnitude of these costs with respect to different areas in principal countries.
- The impact of these costs on the Soviet economy and its growth.
- How Moscow looks at the "burden of empire."
- Finally, in what ways the "burden" might become a source of US leverage with Moscow.

What Is the Soviet Empire?

4. The Soviet empire can be thought of as a series of concentric circles, the nearest of which to the Soviet core have the closest relationship with the USSR. Beginning from the inner circle and moving out:

- The Inner Core: The East European countries, excluding Yugoslavia, plus Mongolia, constitute the inner core of the empire. These countries are all military allies of the USSR; Soviet military forces are either in place or have quick access to these countries. Preservation not only of the military alliance, but also of a Communist system basically modeled after that of the USSR, are viewed by Moscow as matters of vital national interest. Moreover, common institutions result in common economic problems, especially development of industries which, although useful to build military power and fill basic consumer needs, are rarely competitive in Western markets.
- Other Communist Clients: Other, mostly non-contiguous, Communist countries, such as Cuba and Vietnam, plus probably North Korea and Afghanistan, have close military and economic relations with the USSR. Preservation of these relations and of a Communist political and economic system in these countries are matters of very high priority to Moscow, if not of truly vital national interest. In addition, Cuba and Vietnam actively provide Moscow with important military facilities and also serve Soviet interests by projecting military power and political influence in their

areas of interest. These countries are not linked to Moscow by formal treaties, however, and Soviet military power can have access to them only by invitation.

- <u>Non-Communist Clients</u>: Next on the list of Soviet priorities and closeness of ties is a group of Third World countries, notably Angola, Ethiopia, Mozambique, South Yemen, and increasingly Nicaragua, which are Soviet clients in the sense of having become politically and militarily dependent on Soviet and/or Cuban military support to sustain their political system and foreign policy. Some of these countries, moreover, give Moscow limited basing rights for its military forces. While Moscow gives preservation of ties with these countries a high priority, it is neither able nor willing to make firm commitments for continuing military or economic support. Nevertheless, these countries are included in what NATO defines as the Soviet "client states" and have many characteristics of subordinate states in an empire.

- <u>Regular LDC Aid Recipients</u>: Next we have a group of developing countries with large continuing military and economic links with the USSR but whose domestic and foreign policies are largely independent even though in some countries there may be substantial Soviet influence, particularly on foreign policy. These countries include India, Libya, Iraq, Syria, Algeria, and Peru.

- <u>Occasional LDC Aid Recipients</u>: Finally, we have a substantial number of Third World countries who receive some Soviet economic and/or military assistance but not on a scale sufficient to give Moscow much influence over their policies. These countries should probably not be considered to be part of the Soviet empire, even though [redacted] does include some of them in that concept. 25X1

<u>Types of Costs</u>

5. Moscow provides assistance to the various parts of its "empire" in the following forms:

- Price subsidies on exports of civilian and military goods and occasionally concessionary prices on imports.

- Direct grants, mainly for military deliveries.

- Credits on concessionary terms for trade, development, and military purposes.

This assistance consists only in part of costs actually incurred as a result of a transfer of resources from the USSR to the recipient. A large part (the price subsidies) consists of opportunities theoretically foregone by Moscow to gain higher prices on world markets.

6. The various types of costs change considerably from year to year, depending on such factors as world market prices, economic or political emergencies and new political or military opportunities and problems in the Third World. As table 1 shows, price subsidies have been by far the largest form of assistance, averaging nearly $20 billion a year in 1980-82.

7. Price subsidies on non-military trade occur almost exclusively in trade with Communist countries. The prices of primary products in trade among Communist countries have generally been based on a moving average of world market prices. The purpose of this approach is to maintain a link with the world market while avoiding the potentially disruptive impact of large price fluctuations on the planned economies of the Soviet Bloc. Over the years the net impact of this dampening of world market price fluctuations is supposed to cancel out, and it has probably about done so, with the notable exception of petroleum.

8. For petroleum the CEMA countries agreed to use a five-year moving average of world prices in 1975, a procedure which greatly reduced Moscow's windfall gain as the result of the 1973 and 1979-80 oil price increases and greatly eased the adjustment of other Communist countries to the surge in world oil prices. With world oil prices trending downward over the past two years, however, intra-Bloc oil prices have caught up and the annual subsidy has disappeared.

9. Another exception is the pricing of Soviet sugar imports from Cuba at negotiated levels, recently over five cents a pound, which in many years exceed world market prices by a wide margin and are sometimes four or five times greater than the world market.

10. In the case of manufactured goods, prices in intra-Communist trade are negotiated on the basis of price information on contracts and trade among Western countries for similar products. The procedure tends to yield prices which are substantially higher than those Communist countries could actually earn for their products in Western markets. The difference between calculated prices and the actual or potential selling price in the West probably ranges between 20 and 50 percent. It reflects not only the generally lower quality of Communist country products, but also the fact that few of these products are designed or packaged appropriately for sale in Western markets and that the Communist countries generally lack the marketing contacts and reputation of major Western firms. The tendency to overprice, by Western standards, manufactured goods in intra-Communist trade, has favored the East European countries in their trade with the USSR because they are substantial net exporters of manufactures to that country. In effect, most East European manufacturing industries, having been developed to meet domestic and Soviet needs, and able to sell in protected bloc markets, are uncompetitive in Western markets.

11. Moscow has frequently sold arms to developing countries at discounted prices. The USSR develops basic price lists for arms sales to

developing countries which, although probably not directly based on prices of Western arms, are at least designed to be generally competitive with the West. Consequently, price discounts do generally represent a form of price subsidy, although in some cases they may be necessary to overcome political resistance to buying Soviet arms. We know little about how arms sales are priced in intra-Communist trade.

12. As far as we know, Moscow has provided direct grants for economic or military purposes almost exclusively to Communist countries. We believe that Soviet military aid to Cuba and Vietnam, for example, is on a grant basis. Military sales to Eastern Europe, however, are probably strictly on a commercial basis. Grants have averaged about $2 billion a year during 1980-82.

13. The USSR provides credits to both Communist and non-Communist countries to finance economic development, trade, and military purchases. Most of these credits are on highly concessionary terms, although the subsidy element has varied greatly from year to year because Soviet credit terms change little while world market interest rates show large swings. Typically, Soviet development credits are for 10 or 12 years, trade credits for 5 to 7 years, and military credits for 5 to 7 years. Interest rates run from about 2 to 7 percent. They appear to be fairly similar for Communist country and non-Communist LDC recipients. In some cases, the concessionary credit terms have been necessary to induce third world countries to accept Soviet products. In other cases there may turn out to be little distinction between credits and grants. For example, Moscow has provided Cuba with large annual credits to cover current account deficits, but it is exceedingly unlikely that the massive Cuban debt will ever be repaid. By the same token, no payments have been or are likely soon to be made on earlier credits for military purposes to Egypt.

14. Because of the difficulty of measuring the concessionary element in Soviet credits, the cost of these credits to the USSR can probably best be approximated, in the case of bilateral account partners by the Soviet current account surplus with these countries, and in the case of hard currency partners by credit disbursements less repayments. As shown in table 1, flows on credit accounts have been substantially larger than the grants (over $5 billion a year for Communist countries and $9 billion overall). Some credit aid--for example, to Cuba--has been consistently large over the years. Other credit aid--for example, to Eastern Europe--has generally been small, with occasional spurts due to political and economic events requiring emergency assistance, such as to Poland in 1980-81.

The Cost in Each Major Area and Country

15. The costs incurred by Moscow on different groups of countries (table 1), reflect not only the importance of the countries to Soviet national interests but also the size and strength of their economies and

Moscow's ability to minimize costs by influencing the country's economic policies (table 2). For example, Cuba generally receives far more Soviet assistance than East Germany because its economy is so weak and dependent, even though it clearly represents a less vital Soviet interest. Probably the most critical determinant of the costs of empire is whether or not a country has a Communist government. The bulk (generally over 70 percent) of the trade of all Communist countries is with the USSR and its allies. Although Moscow tries to minimize its economic costs and to increase its economic benefits by influencing the economic policy of its Communist partners, in the final analysis, Moscow has no choice but to support these economies, however reluctantly. By contrast, none of the Soviet client states and aid receipients which do not have Communist governments rely on the USSR and other Communist countries for more than 20 percent of their foreign trade. Moscow does provide economic and military aid to buttress foreign policy relationships with these countries, but on a very limited scale.

16. The total cost of supporting Eastern Europe has consisted predominantly of price subsidies in recent years, with an average of \$18 billion in 1980-82, but will probably settle in the range of \$10 to 15 billion, because of the disappearance of oil price subsidies. Most of the remaining costs will be due to overpricing of Soviet imports of East European manufactures, with a small part representing development aid on concessionary terms. Among the East European countries, East Germany and Czechoslovakia probably are the largest continuing recipients of Soviet price subsidies because they have the largest export surpluses of trade in manufactures with the USSR. The net flow of Soviet credits to Eastern Europe has been small in most of the past decade, a few billion dollars at most.

17. The high import dependence of the Cuban economy and the US embargo on trade with Cuba have forced Moscow to provide large-scale economic support to Cuba on a continuing basis by one means or another. Soviet aid not only is built into long-term economic agreements with the Cubans, but also is adjusted in response to fluctuation in the Cuban sugar crop, world sugar prices, and other unexpected developments. The cost of supporting Cuba rose to over \$5 billion in 1980-82, reflecting primarily a stable Soviet price of over 5 cents a pound for Cuban sugar at a time when the world sugar price collapsed. Cuba also received a large subsidy on its imports of Soviet petroleum although, as in Eastern Europe, the subsidy element has been disappearing. Unlike Eastern Europe, however, Moscow also has covered large annual Cuban current account deficits with low interest credits, which might as well be considered grants. In the longer term, the cost of annual Soviet aid to Cuba will probably be in the range of \$2 to \$4 billion given more normal world sugar prices and, as mentioned above, Cuba receives a large volume of Soviet military equipment and other military services free of charge.

18. The other large Communist recipient of Soviet assistance is Vietnam, which, like Cuba, runs substantial annual deficits on its trade with the USSR and in addition receives large amounts of free military assistance. This cost averages over $ 1.5 billion a year.

19. Soviet assistance to non-Communist client states--Angola, Ethiopia, Mozambique, South Yemen--is primarily in the form of concessionary credits which are likely to be only partly repaid. The net cost to the USSR is probably of the order of $1 - 2 billion dollars a year.

20. The long-term LDC aid recipients who are not client states receive most of their assistance on military account. Most Soviet arms are paid for in hard currency. Although none of the military sales are grants, Moscow has sometimes deferred payment, as currently in the case of Syria and perhaps Iraq; resulting in net cost to Moscow of perhaps $1 to 2 billion a year.

21. Moscow incurs only minimal costs in its aid to occasional LDC recipients. These costs reflect mostly concessionary military credits. Economic aid is small and the net flow of resources on economic aid account generally in favor of the USSR.

22. The overall "cost of empire," including "opportunity costs," was probably about $25 billion at peak for Communist countries and $30 billion for the broader "empire." On a longer-term basis, these costs can be expected to decline to about $15 - 25 billion. If "opportunity costs" are excluded, total costs are likely to be about $10 - 15 billion.

The Opportunity Cost Problem

23. Any assessment of the economic burden of empire must take into account the large uncertainties and ambiguities in the concept and measurement of opportunity costs.

(i) The prices of manufactured products in Soviet trade with Eastern Europe that could actually be obtained in Western markets are highly uncertain. The extent to which these products are overpriced in intra-bloc trade not only differs from item to item but also tends to diminish the longer the time allowed for adjustment. The products are not designed for Western markets. Given enough time and considerable expense many of them probably would find hard currency markets at a substantially higher price than if they had to be dumped quickly.

(ii) Soviet trade with Eastern Europe brings economic benefits to the USSR which may compensate in part for the higher prices paid for manufactures. This trade is planned, stable, and fairly reliable--all important virtues for planners, managers, and producers in a Communist-type economy.

(iii) The appropriate exchange rate for converting dollar estimates of opportunity costs into domestic rubles is uncertain. [redacted] 25X1 uses a rate calculated from the ratio of the actual ruble value (at domestic selling prices) of all imports to their dollar value. Many imported goods are sold domestically at prices much higher than those of the closest domestic substitutes. This reflects partly the higher quality of imported goods, partly the fact that consumers will pay premium prices for imported areticles for a variety of reasons, and partly because the government wants to discourage the use of imports. [redacted] ruble conversion 25X1 procedure is defensible, but probably tends to overstate ruble opportunity costs.

(iv) More basically it is not obvious why increased trade with the West should be considered the most relevant alternative to Soviet trade with Eastern Europe. Another alternative would be shifting the factors of production used to produce exports for Eastern Europe to domestic uses. By this criterion, economic relations with Eastern Europe are a "burden" only if the factor cost of Soviet exports to Eastern Europe exceeds the factor cost of producing substitutes for imports from Eastern Europe. It is highly probable that the Soviet economy gains from trade with Eastern Europe, although there is no way these gains can be measured. The East European countries provide the Soviet Union with consumer goods and capital goods that are often of better quality than their Soviet counterparts and in some cases incorporate Western technology, the purchase of which Moscow could not easily afford. Moreover, although the domestic cost of producing oil and other minerals for export to Eastern Europe has been increasing rapidly, so have the prices Moscow changes for these exports, and consequently Moscow's terms of trade with Eastern Europe have improved, probably by about one-third since the early 1970s.

24. These considerations suggest that the [redacted] estimate of the burden 25X1 of Soviet empire of up to 7 percent of GNP (about 5 percent of GNP if we include only Communist states and exclude foreign intelligence expenditures) is misleading. If we include opportunity costs in assessing the burden, these figures should be treated as upper limits of a range of possibilities, with the lower limit being indeterminate. Without counting opportunity costs, the cost of empire in rubles is probably less than 1 percent of GNP.

Impact on the Soviet Economy

25. Although opportunity costs can be calculated and compared with Soviet GNP, they should not be treated as additions to the Soviet defense burden because they do not represent realized factor costs. If Moscow had obtained better terms in its trade with Eastern Europe, or shifted some of this trade to the West, its GNP presumably would have grown more than it did, and consequently, if defense expenditures had not been affected, the defense burden would have been slightly reduced. But realizing these opportunities for larger gains from trade could have had serious negative

repercussions in the East European economies, leading perhaps to greater political instability and a requirement for an increase in more direct Soviet foreign economic assistance. Moreover, greater political instability in Eastern Europe could have resulted in an increase in the military expenditures Moscow would need to achieve the same degree of national security.

26. The burden of keeping some of the noncontiguous Communist countries, notably Cuba and Vietnam, in the Soviet empire almost certainly does entail substantial net costs to the Soviet economy. The chances are that Moscow could expand domestic sugar production fairly sharply to compensate for any loss of imported Cuban sugar. In effect, Moscow gets very little of economic value in return for its substantial exports of manufactures and food to both countries.

27. The cost of assistance to Third World countries is probably too small to have any significant effect on the Soviet economy. There is probably a net loss on transactions with Ethiopia and South Yemen and a net gain for most other transactions with Third World countries.

28. It is important to keep in mind that almost none of the Soviet costs of empire entail direct expenditures of hard currency. Virtually all Soviet aid to both Communist and non-Communist countries is tied to deliveries of Soviet products, and in those few cases where the Soviets have made hard currency payments, it was for purchases Moscow would otherwise have had to make in Western markets in any event. Moscow apparently has consistently maintained a firm policy against any out-of-pocket hard currency expenditure; this policy has severely restricted Moscow's ability to compete with the US or other Western countries in aid to the Third World.

29. Moreover, the commodity composition of Soviet assistance to both Communist and non-Communist countries tends to hold down the cost to the Soviet economy. A substantial part of assistance to Communist countries outside of Eastern Europe and the greater part of assistance to Third World countries consists of arms provided on a grant basis, at discounted prices, or on soft credit terms. The USSR is a relatively efficient and low cost producer of most military equipment, particularly the relatively simple equipment that predominates in Soviet arms exports. This is because Soviet production runs are long, equipment is highly standardized, and technical improvements are evolutionary.

30. In any event, although the Soviet economy could have benefited from a smaller increase in assistance to various parts of the "empire," especially Eastern Europe and Cuba during the 1970s and early 1980s, the marked slowdown in Soviet economic growth during this period cannot be blamed on the burden of empire. As mentioned before, the evidence indicates that the Soviet gains from trade with Eastern Europe were increasing markedly during the period, almost certainly offsetting losses from trade with other Communist countries.

Soviet Perspectives on the Cost of Empire

31. It is unlikely that the Soviet government makes overall assessments of the cost of empire which cover its relations with both Communist and non-Communist countries. There are clear indications, however, that Moscow has become increasingly concerned to hold down the cost of and to increase benefits from foreign economic and military activities. Recently the Soviets have been improving their terms of trade with Eastern Europe, pressuring Cuba to reduce its requirements for Soviet aid, warning non-Communist clients not to expect open-ended Soviet assistance, and slowly tightening credit terms on loans to other LDCs. At least to some extent this trend may reflect the growing Soviet economic stringencies due to a marked slowdown in the growth of the Soviet economy. This suggests that whatever Moscow may consider the burden of empire to be, it would like to reduce it.

32. In dealings with Eastern Europe, the Soviets not only have raised their oil export prices to at least the world market level, but also have reduced the volume of their oil exports and are trying to force the East European suppliers of machinery and consumer goods to improve the mix and quality of their products. Moscow clearly sees no reason to help Eastern Europe out of its economic difficulties at the expense of its own, troubled economy. But there are limits to how far Moscow can push its allies. If the East European countries' terms of trade with the USSR worsen much more, they would benefit from diverting some exports of manufactured goods to Western markets, despite the low prices these would earn.

33. Moscow has little choice to continue supporting Cuba and Vietnam at at least a tolerable economic level, but is doing so reluctantly. Soviet statements and behavior suggest they have a great reluctance to provide greatly increased assistance to such non-Communist clients as Mozambique, Angola, and Ethiopia. Apparently the Soviets do not want these countries to become new Cubas, unless perhaps Moscow can acquire control over their policies. In relations with the Third World generally, the Soviets appear to be distinguishing between nearby states, especially in the Middle East in which the USSR has a major historic interest, and faraway states. It is evident that substantial economic aid to faraway states that are not Communist controlled is extremely unpopular in the USSR.

The Cost of Empire as a Source of US Leverage

34. Certain US actions could either raise the cost to Moscow of maintaining its influence in third countries, or induce a decline in Soviet influence if Moscow were unwilling to incur larger costs. The potential for US influence depends on the importance to Moscow and the particular third country government of its relationship with the USSR, and on the amount of economic leverage the US, with its Allies, can exercise--which in turn depends primarily on the particular country's dependence on economic relations with the West.

35. At the lower end of the scale of priority--the countries to which Moscow gives occasional aid and probably most of the regular LDC recipients of Soviet aid--US actions would not significantly increase Soviet costs, but could be successful in reducing Soviet influence. If these actions involve out-competing Moscow on economic aid programs or arms sales, any decline in Soviet influence would be purchased at the cost of a larger economic burden. For the United States this burden might be quite large because the USSR plays a very minor role in the economic aid to or arms market of developing countries which are not Soviet client states. Should the US give countries like Bangladesh, Mali, Nigeria, or even India, more assistance in order to reduce Soviet influence, there would be increased pressure to ease terms on aid to other developing countries as well. The basic problem with trying to out-compete Moscow with this group of countries is that their priority to Moscow is low, Soviet influence is small, and the cost to the USSR is minimal.

36. At the other end of the scale, US actions could increase the cost to Moscow of maintaining its East European empire, but would not be likely to reduce Soviet control over and influence in those countries. Unilateral US economic leverage, however, is small because East European countries trade mainly with Western Europe and some developing countries, and Western cooperation is difficult to obtain. Moreover, at least to some degree the US objective of giving East European countries opportunities and incentives to increase their links with the West and reduce those with the USSR would probably be fostered by trade expansion rather than trade restriction. Even so, even selective restrictions on trade with or credits to Eastern Europe probably do force Moscow to carry at least some of the resulting economic cost.

37. Moscow almost certainly would be willing to accept an increased economic burden in order to protect its principal Communist LDC clients, especially Cuba and Vietnam, from the impact of Western economic sanctions. Cuba's status as a bastion of Communism in the Western hemisphere not only provides a major base for Communist penetration in Latin America, but also diverts major US military forces from other uses. As a major power in Southeast Asia, a Communist Vietnam also is a useful springboard for Soviet influence and in addition ties down large Chinese forces along the border. North Korea, although retaining considerable independence of action because it is able to balance Chinese and Soviet influence, is an important military power which keeps US troops tied down and provides a source of pressure on Japan. Western ability to increase the burden to Moscow of supporting these countries, however, is limited by the fact that only a small share of their trade is with the West. In the case of Cuba, the US embargo and other sanctions have already had a major impact; with Communist countries accounting for 80 percent of Cuban trade, little in the way of major economic levers remain. Even so, Moscow would have to make up at least part of the cost to Cuba of any additional Western actions, such as further reductions in the flow of credits and restrictions on purchasing additional amounts of Cuban nickel. Moreover, even if the

Soviet burden is not increased, there may be possibilities for exploiting Soviet and potentially East European dissatisfaction with the fact that the burden is already large, and has been rising at a time when Soviet assistance to Eastern Europe was falling.

38. The best opportunities to use Soviet "costs of empire" as a basis for policy leverage probably exist in the non-Communist client states--Angola, Mozambique, Ethiopia, South Yemen, and perhaps Nicaragua. Moscow has large foreign policy interests and some military interests in these countries, and already incurs substantial costs to preserve the relationship. But the West, not the US alone, retains major potential leverage because it still provides the sources of most of the countries' export earnings and government revenue. Major Western economic sanctions or inducements would substantially raise the costs to Moscow of protecting its political and military interests. Perhaps more likely, in some cases, given the Soviet reluctance to incur such added costs, would be a weakening of Soviet ties. The fundamental problem is the great difficulty of achieving any substantial coordination among Western countries in the use of policy instruments.

Table 1

Cost of the Soviet Empire (Billion Dollars; annual averages)

	1980-82					Longer-Term	
				Total		Total	
	Grants	Net Credits	Price Subsidies	Including Subsidies	Excluding Subsidies	Including Subsidies	Excluding Subsidies
A. Inner Core		3.8	15.0	18.8	3.8	10-12	3-5
Eastern Europe	--	3.0	15.0	18.0	3.0		
Mongolia	--	0.8	--	0.8	0.8		
B. Other Communist Clients	2.3	1.8	4.0	8.1	4.1	4-8	4-5
Cuba	0.7	0.7	4.0	5.4	1.4		
Vietnam	0.8	0.8	--	1.6	1.6		
Other*	0.8	0.3	--	1.1	1.1		
C. Other Client States		1.6	--	1.6	1.6	1-2	1-2
Angola		0.5	--	0.5	0.5		
Ethiopia		0.5	--	0.5	0.5		
Mozambique		0.2	--	0.2	0.2		
Nicaragua		0.1	--	0.1	0.1		
South Yemen		0.3	--	0.3	0.3		
D. Long-Term Aid Recipients**	--	1.5	--	1.5	1.5	0-2	0-2
E. Occasional Aid Recipients	--	0.5	--	0.5	0.5	0-1	0.1
Total Communist	2.3	5.6	19.0	26.9	7.9	15-20	7-10
Total Communist plus Clients	2.3	7.2	19.0	28.5	9.5	16-24	8-12
Grand Total	2.3	9.2	19.0	30.5	11.5	16-25	8-15

* Afghanistan, Kampuchea, Laos, North Korea.

** Algeria, Egypt, India, Iran, Iraq, Libya, North Yemen, Peru, Syria, Turkey.

Table 2

Factors Affecting the Cost of Empire

	Importance to Moscow	Soviet Influence	Total Exports (bil. $)	Percent to Communist Countries
A. Inner Core	Vital	High		
Eastern Europe			90	67
Mongolia			.2	100
B. Other Communist Clients	High	Substantial		
Cuba			6	85
Vietnam			.3	90
Other			2.1	64
C. Other Client States	Substantial	Moderate		
Angola			.7	negl
Ethiopia			0.4	negl
Mozambique			.2	negl
Nicaragua			.4	14
South Yemen			.2	10
D. Long-Term Aid Recipients	Moderate	Low	64	10